Regulations Improve the Free Market? It Just Ain't So!

BY ARTHUR E. FOULKES

Despite its remarkable record the free market remains for many people a tough sell. Even those who on balance support free enterprise hesitate to give unregulated market forces their full endorsement. After all, they argue, the market sometimes "fails," requiring corrective measures at the hands of wise government authorities.

One such qualified endorsement of market freedom appeared last May in a syndicated column by Knight Ridder journalist Jeff Brown. After remarking—paraphrasing Churchill—that "a market economy is the worst system—except for all the others," Brown goes on to list several examples of what he called "market-force failure." His examples include real-estate commissions, medical costs, credit-card interest rates, and CEO compensation. Each has remained "high" he says, despite increased supply, increased competition, or both. Regulatory intervention, he concluded, is therefore justified.

Brown argues that the real-estate market has "failed" because commissions have "held at 6 percent for ages," despite what he asserts is "a huge oversupply of brokers." But the truth is, as housing prices have soared (in many areas) and more competitors have entered the real-estate business, commissions have been falling. According to a survey published by REAL Trends, an information and consulting firm for real-estate professionals, average 2002 commissions were only slightly above 5 percent nationwide—down from about 5½ percent the year before. Many home sellers are using newly formed "flat rate," or discount, realty companies, while others are opting against using an agent at all. In response, even some old, well-established firms, such as Coldwell Banker, have started experimenting with heavily discounted commission rates.

It is true that some consumers may continue to pay 6 percent commissions, but even this is not due to "market failure." They may prefer an excellent broker who can insist on 6 percent (or more), or they many not like to haggle.

An even less likely place to look for market failure is in the U.S. medical market. Certainly there are glaring—even tragic—distortions in this market, but they are in no way a result of the free market. On the contrary, the significant economic problems associated with medical care all stem from government interference with the market.

For instance, a government-backed cartel has long sought to keep the supply of doctors and medical services low relative to demand. A single paragraph from an article in *USA Today* (March 2) nicely sums up the problem: "The marketplace doesn't determine how many doctors the nation has, as it does for engineers, pilots and other professions. The number of doctors is a political decision, heavily influenced by doctors themselves."

Until recently professional medical organizations, including the highly influential American Medical Association (AMA), have warned of a doctor surplus in America. Only lately have these organizations admitted that the feared doctor glut was an illusion. As Richard Cooper, director of the Health Policy Institute at the Medical College of Wisconsin, told *USA Today*: "We face at least a decade of severe physician shortages because a bunch of people cooked numbers to support a position that was obviously wrong."

On top of this, licensing laws drastically restrict the supply of medical services. Working through state and

Arthur Foulkes (arthurfoulkes@hotmail.com) teaches government and politics at Northwood University in Indiana.

federal lawmakers for over 100 years, the AMA has managed to sharply restrict the number of approved medical schools as well as prevent nonphysicians, such as homeopaths, nurse practitioners, midwives, and chiropractors, from legally performing medical services they are otherwise qualified to administer.

Meanwhile, the demand side of the medical market is also seriously distorted. As a result of Medicare, Medicaid, and government tax incentives for employers to provide low-deductible medical insurance, few Americans pay for care out of pocket. This artificially inflates consumer demand.

Thus there is no market failure in medicine, only a double squeeze on market participants from both the supply and the demand side.

Credit-card interest rates are another area of apparent market failure, according to Brown. In his words, "Many credit cards carry interest rates in the teens even though consumers have lots of choice and other interest rates have been at rock-bottom levels for years."

A recent Federal Reserve Bank of Chicago study noted several market-based reasons for relatively high rates, including the risk to banks of unsecured loans and a propensity for consumers to disregard credit-card rates because they believe (wrongly in many cases) they will pay their balances in full each month. (See www.chicagofed.org/consumer_information/controlling_interest.cfm.)

Still, the same report noted (just as economic theory would suggest), real or perceived "high" profits in the credit-card industry have attracted "a host of new competitors" who have intensified "competition in terms of both service and price." This has come in the form of lower interest rates, "buyer protection plans," rebate programs, and mediation services in the event of a conflict between buyers and sellers. (See J.H. Huebert, "Free-Market Justice Is in the Cards," *The Freeman*, April 2005.)

It is also possible to argue that—at a fundamental level—central-bank (that is, government) intervention in the overall credit market has also contributed to today's relatively high credit-card rates. By artificially lowering interest rates in recent years, the Federal Reserve has made interest-bearing assets, such as bonds, less attractive and, conversely, made present-oriented consumption more attractive. The resulting heightened demand for spending means greater demand for (and thus higher prices for) credit-card and other types of short-term consumer borrowing. In this way, the Fed can be seen to have indirectly increased credit-card rates even while keeping other rates down.

Executive Pay

Finally, Brown points to executive compensation as another area of market failure, noting that CEO pay "continues to soar" while there are "legions of managers who'd do anything for shots at the top jobs."

Here Brown is touching on what economists call the "agency problem." Because individual corporate shareholders have little incentive to spend the time and effort to monitor executive pay, corporate managers, it is said, are in a position to greedily extract huge salaries.

> The market has its own solution to the agency problem; it's called the "hostile takeover."

Yet the market has its own solution to the agency problem; it's called the "hostile takeover." When a company is poorly managed, outside investors ("raiders") begin buying shares of the company from ready-to-sell shareholders. Once a takeover is complete, the new owners dismiss the poor management and replace it with their own. Thus the takeover is the shareholder's best defense against bad management.

But, alas, terms like "hostile takeover" and "corporate raider" have helped give this market process a bad name, while powerful CEOs have been able to persuade national and state lawmakers to severely restrict the takeover process. Again, government intervention—not market failure—is the root of the problem.

Brown ends with an appeal for new government regulations, although most of the problems he identifies have their roots in previous government regulations. These regulations have created waste, politically driven wealth redistribution, and other harmful market distortions. More government intervention is not the answer; freedom is.